



RESEARCH BRIEF

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Sovereign Debt Restructuring: The Potential Role of China in the Belt and Road Initiative in the Post COVID-19 Era

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Key Points:

- Strengthening and safeguarding the financial systems of Belt and Road Initiative countries requires a coherent and comprehensive global approach to restructuring sovereign debt.
- One of the key defects of China's sovereign debt restructuring framework is the absence of a centralised adjudication body to handle disputes related to sovereign debt.
- As one of the world's largest creditors, the Chinese government could take the lead in establishing an international arbitration and mediation centre and specific arbitration, mediation, and expert determination regimes for sovereign debt-related disputes, thereby bolstering the stability of global financial markets and the confidence of future investors.

Introduction

Sovereign bonds have become a major asset category in recent decades. Due to the fallout of the 2007-2009 financial crisis and the accompanying sovereign debt crisis, the interconnected nature of sovereign debt management, financial stability, and systemic risk has been brought into sharp focus. Due to heightened financial fragility, the additional pressure of the COVID-19 pandemic has set the stage for a debt crisis and potentially a serious economic catastrophe. Therefore, an efficient system of sovereign debt restructuring (SDR) is becoming increasingly important for international financial stability.

China has received a wave of requests for debt relief from crisis-stricken nations participating in the Belt and Road Initiative (BRI), the world's largest economic initiative, due to higher government expenditure and reduced tax collection in the wake of the COVID-19 epidemic. There are no uniform guidelines that address SDR

* Part of this Research Brief is based on my work-in-progress paper on Chinese approach to sovereign debt restructurings and my work-in-progress doctoral thesis on sovereign debts.

and default among BRI nations. Instead, SDR is currently operating on an ad hoc basis.

There is also no universal international sovereign debt regime for BRI nations to address disputes regarding SDR under the BRI. Further, there is increasing concern about current approaches to SDR. China is now establishing a framework to improve the sovereign debt management system, including practical debt sustainability evaluation standards and a standardised SDR procedure for foreign sovereign debtors.¹ However, it has a long way to go.

This Research Brief highlights one of the key defects of China's SDR framework - the lack of a centralised adjudication body to handle SDR-related disputes. The Brief argues that China, as one of the world's major creditors, has the exceptional ability to assist in resolving the issue of unsustainable sovereign debt by altering current policies. Ideas for consideration by the Chinese government are also presented.

Overview of the Current Sovereign Bond Market in China

Generally speaking, '[t]he market for sovereign debts... [has grown] ...over time and there were several changes in the nature of the bondholders and banks'.² Recently, creditors for many sovereign debtor countries have received a wave of applications for debt relief due to the impact of the COVID-19 crisis on those countries. Two shocks will hit the BRI's debt dynamics: a pandemic stimulus and post-pandemic economic

fallout. Regarding the pandemic stimulus shock that hit the debt dynamics, the economic fallout of the COVID-19 pandemic has pushed the sovereign states' governments to take expansionary measures in this challenging situation. The increase in government expenditure during the pandemic raised the incentive of developing countries to issue bonds offshore. Moreover, some countries are considered to have a relatively high sovereign credit risk. International sovereign debt soared due to the worldwide economic downturn caused by the pandemic.

There is rising concern over China's sovereign debt practice.³ There is also a widespread misconception amongst journalists and politicians that Beijing utilises foreign assistance (including both commercial loans issued by state-owned financial institutions and sovereign credit) to prop up rogue regimes or to control other nations via debt. However, these beliefs are often supported by nothing more than speculation, hearsay, or studies that lack sufficient empirical backing (before the establishment of AidData). This is due to the fact that data on China's financial aid programmes is often spread out over thousands of documents and in dozens of languages. Although China lends money commercially, it does not publish information about its commercial lending operations or disclose information about its assistance programmes via international reporting systems like the Organization for Economic Cooperation and Development's creditor

¹ Zhou Chengjun, *Building the Shanghai Model of Sovereign Debt Restructuring* (构建主权债务重组的上海模式), Speech at the fourth China International Finance 30 Forum, Shanghai (July 31, 2021).

² KIM OOSTERLINCK, *The Historical Context of Sovereign Debt*, in SOVEREIGN DEBT AND HUMAN RIGHTS (Ilias Bantekas & Cephas Lumina, eds., 2022) 13.

³ Sam Parker & Gabrielle Chefitz, *Debtbook Diplomacy: China's Strategic Leveraging of Its Newfound Economic Influence and the Consequences for U.S. Foreign Policy*, Belfer Center for Science and International Affairs, Harvard Kennedy School Paper (May 24, 2018), <https://www.belfercenter.org/sites/default/files/files/publication/Debtbook%20Diplomacy%20PDF.pdf>.

reporting system. In addition, it uses stringent confidentiality rules to keep its lending and financing operations under cover. Yet, the evidence basis for examining the aims and impacts of China's sovereign debt practice can be formed by 'employing a new set of data collection methods'.⁴

Key Defect of The Current Approaches for Sovereign Debt Restructuring

As it stands currently, the mechanisms to deal with SDR among BRI countries are not harmonised, vary from country to country, and are mediated through a range of different procedures - described as a 'non-system'.⁵ Further, commentators have observed that 'the "non-system" of sovereign debt restructuring is solely lacking - fragmented, inconsistent, and providing insufficient relief to reboot economic growth'.⁶ At the international level, the current regulations on SDR are fragmentary. There is no single 'court' (i.e., 'adjudication' body) for sovereign debt restructuring-related disputes at the international level. In practice, the major forum for considering such disputes is the domestic courts.⁷

The Supreme People's Court (SPC) in China formally launched two branches of the International Commercial Court of China (CICC) in 2018 to adjudicate international commercial

disputes, where the CICC is supposed to take on disputes pertaining to sovereign debt due to their international commercial nature. The establishment of the two branches of the CICC is driven by China's desire to facilitate dispute resolution related to the BRI. It has been noted that the 'SPC takes a flexible and pragmatic approach in the establishment of the CICC'.⁸ While 'the current legal framework for the CICC came into shape, compared with other commercial courts globally, there are still ambiguities and obstacles in the operations of the CICC'.⁹ For example, the CICC does not have jurisdiction over cases concerning investor-state disputes.¹⁰ However, the SPC judges stated that the CICC would accept primarily international commercial disputes between equal commercial entities.¹¹ In addition, China's specialised bankruptcy courts are limited to domestic bankruptcy proceedings and do not take sovereign debt claims. Therefore, there is no bankruptcy court and no code for private investors in the BRI to claim debt obligations against countries who cannot pay off their debt, and to initiate SDR.

Potential Reforms

Potential changes to the drafting of future international investment agreements (IIAs) between China and other BRI countries are likely

⁴ AXEL DREHER ET AL., *BANKING ON BEIJING: THE AIMS AND IMPACTS OF CHINA'S OVERSEAS DEVELOPMENT PROGRAM* 24-25 (2022).

⁵ ANNA GELPERN, *Hard, Soft, and Embedded: Implementing Principles on Promoting Responsible Sovereign Lending and Borrowing* in *SOVEREIGN FINANCING AND INTERNATIONAL LAW: THE UNCTAD PRINCIPLES ON RESPONSIBLE SOVEREIGN LENDING AND BORROWING* (Carlos Espósito, Yuefen Li & Juan Pablo Bohoslavsky eds., 2012).

⁶ Odette Lienau, *The Challenge of Legitimacy in Sovereign Debt Restructuring*, 57 *HARV. INT'L L.J.* 151, 153 (2016).

⁷ MICHAEL WAIBEL, *SOVEREIGN DEFAULTS BEFORE INTERNATIONAL COURTS AND TRIBUNALS* 63-64 (2011); Julian Schumacher, Christoph Trebesch & Henrik Enderlein, *What*

Explains Sovereign Debt Litigation? 58 *THE J. L. AND ECON.* 585 (2015). For example, Argentina's sovereign debt case was held in the court in United States.

⁸ Sheng Zhang, *China's International Commercial Court: Background, Obstacles and the Road Ahead*, 11 *J. INT'L DISP. SETTLEMENT* 150, 161 (2020).

⁹ *Id.*

¹⁰ *Id.*

¹¹ CICC, 'The State Council Information Office Held a Press Conference on the "Opinion on the Establishment of 'The Belt and Road' International Commercial Dispute Settlement Mechanism and Institutions"' (June 28, 2018), <https://cicc.court.gov.cn/html/1/219/208/210/769.html>.

to be required in the post-COVID era. In the future, drafters of IIAs will need to anticipate the impact of COVID-19 (and other similar global health pandemics) on an investment. For instance, future IIAs may be structured in a way that can identify the parties that will have difficulty fulfilling their obligations and the situations that could give rise to a breach of IIAs. Parties who have been identified as having difficulty fulfilling their obligations may delay or cancel their repayment. On the other hand, from the defaulting states' perspective, it could be argued that bilateral investment treaties (BITs) that include investor-state dispute settlement bring more risks than benefits. This is because if they did, creditors might pursue legal action whenever the debtors fail to fulfil their obligations, leaving little room for them to renegotiate with their creditors. In the future, defaulting states might consider taking India as a reference, a country which has exited most of its BITs. The lack of political will of defaulting States might be the potential hurdle for the establishment of international arbitration for sovereign debt-related disputes.

Most of the BITs between China and the countries that have taken part in the BRI are very conservative with respect to the scope of the disputes that can be submitted to international arbitration.¹² To meet the particular needs in sovereign debt disputes that arise out of or in relation to COVID-19, the Chinese government should consider establishing an international arbitration and mediation centre and specific arbitration, mediation, and expert determination

regimes for sovereign debt-related disputes with the assistance of the United Nations Commission on International Trade Law (UNCITRAL) Working Group III (Investor-State Dispute Settlement Reform), as well as the International Commercial Dispute Prevention and Settlement Organization (ICDPASO).¹³ However, the idea of a unified sovereign debt restructuring regime is not novel. The failed proposal of the International Monetary Fund (IMF)'s Sovereign Debt Restructuring Mechanism (SDRM) is one of the examples. The IMF's SDRM needs to be revisited and improved for the establishment of an international regime for sovereign debt disputes. It is vital at this juncture to assess current progress towards the development of a global approach for SDR-related disputes at the international level. The proposed applications of an international regime for sovereign debt disputes would provide better protection for the investors, not just in BRI countries but globally.

The IMF's SDRM could provide a framework for the Chinese government to adopt to incentivise the sovereign debt issuers and creditors to reach an agreement that is mutually beneficial to both in terms of cost and efficiency. This is because the SDRM is the strongest attempt made by the international community to institute a permanent restructuring regime in recent years. However, the IMF's SDRM was rejected in 2003 due to the uncertainty of the outcome that the sovereign bond issuers and private investors could anticipate. Although the IMF's SDRM has been rejected by its member states and subjected to many criticisms, it could still be adopted as a

¹² Shu Zhang, *China's Approach in Drafting the Investor-State Arbitration Clause: A Review from the 'Belt and Road' Regions' Perspective*, 5 THE CHINESE J. OF COMP. L. 79 (2017).

¹³ See Guiguo Wang & Rajesh Sharma, *The International Commercial Dispute Prevention and Settlement Organization: A Global Laboratory of Dispute Resolution with an Asian Flavor*, 22 AJIL UNBOUND 115 (2021).

useful framework (with certain modifications as required) for the effective control and regulation of SDR. More importantly, an international arbitration and mediation regime for SDR in BRI countries is crucial now given the high cost of sovereign debt-related litigations.

A lack of truly independent and impartial arbitrators is one of the key problems of the current investor-state arbitration system. The establishment of an international regime for sovereign debt disputes could maintain a comprehensive list of sovereign debt experts willing to act as arbitrators or mediators. In order to uphold the independence and the impartiality of the list, the Chinese government could take the composition of the European Court of Human Rights (i.e., elected by the Parliamentary Assembly of the Council of Europe from lists of three candidates proposed by each State) as a reference. The composition of the list could be proposed by each BRI countries. Further, a specific set of rules could be developed for resolving disputes in the context of sovereign debt. Most importantly, the IMF could develop a model dispute resolution clause for sovereign bond issuers. For example, the IMF could take the World Intellectual Property Organisation's model alternative dispute

resolution clauses as a reference and provide a set of recommended contract clauses (for the submission of future disputes under a particular contract) and submission agreements for sovereign debt issuers.

Conclusion

A coherent and comprehensive global approach for SDR is necessary to strengthen and safeguard the financial systems among the BRI countries. The existing safeguards for SDR are not sufficient or adequate. The Chinese government, as one of the largest creditors in the world, could take the lead in establishing an international arbitration and mediation centre and specific arbitration, mediation, and expert determination regimes for sovereign debt-related disputes possibly with the assistance of the UNCITRAL Working Group III (Investor-State Dispute Settlement Reform) and the ICDPASO. The establishment of such a centre and regimes would enhance the stability of international financial markets and confidence in future investments.

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